

Core Aggregate Commentary

Third Quarter 2011



Market Review

The U.S. economy likely improved modestly during the third quarter, following the second quarter's sluggish 1.3% annualized growth rate. Economic data continues to support our view that U.S. economic growth will remain tepid for the foreseeable future.

Standard and Poor's downgrade of U.S. government debt and an intensification of the European government debt problems also contributed to the slowing economy. While we expect U.S. growth to improve modestly in the next one to two quarters, the economy remains very fragile. We expect growth to remain sluggish over the next 12 to 24 months, constrained by the stubbornly high unemployment rate, tighter financial conditions triggered by Europe, and low confidence from consumers and businesses.

Following the debt ceiling debate, a congressional "super committee," made up of Republicans and Democrats, was formed and charged with agreeing on \$1.2 trillion of deficit reduction by November to avoid prescribed automatic spending cuts. While they seem to have consensus on the need to reduce the budget deficit, the parties do not yet agree on the methods, and the deficit reduction issue will be highly debated. Policy makers are under significant pressure to reach agreement following the poor handling of the debt ceiling debate and the growing public perception of the budget deficit as a primary political concern. This increases the likelihood of the committee reaching an agreement by the deadline, but Aviva Investors expects the debate to continue adding to market uncertainty and volatility over the near term.

At its August 9 meeting, the FOMC announced plans to "hold rates steady until at least mid-2013." The Fed understands and communicated the limited ability of monetary policy action to directly improve job creation and economic growth. The FOMC followed up by announcing plans to implement Operation Twist at its September meeting. This involves selling \$400 billion in three-month to three-year Treasuries and purchasing \$400 billion in six- to 30-year Treasuries over the next nine months. In addition, the FOMC attempted to support the housing market and mortgage financing by announcing that all agency and agency MBS maturities on the balance sheet will be reinvested into agency MBS. The objective of Operation Twist is to drive longer rates lower and ease financial conditions by removing duration from the market. The announcement resulted in lower rates and a flatter yield curve but did not provide a boost to asset prices.

Instead, risky assets reacted negatively to the dire tone of the FOMC's economic outlook. The September meeting statement highlighted the fragile environment for growth and job creation.

It also indicated that downside risks to growth and financial market turmoil have increased and are being affected heavily by the lack of policy coordination and the absence of a credible solution to the European sovereign debt crisis.

The markets experienced rising volatility, and risky asset classes significantly underperformed in the third quarter. U.S. Treasuries outperformed all other asset classes, as the risk-off environment and flight-to-quality demand drove rates lower. Treasuries generated a 6.48% return, while the S&P 500 returned -13.87%. The 10-year Treasury yield declined 123 bps to a 1.93% yield, while the spread between 10-year and 30-year Treasuries flattened to 100 bps from 121 bps in June. Within the fixed income markets, investment grade credit, high yield and CMBS substantially underperformed Treasuries, with excess returns of approximately -4.75%, -10.35% and -3.6%, respectively.

Investment Outlook

Aviva Investors expects U.S. economic growth to remain sluggish but avoid a double-dip recession, because consumers and businesses are better prepared to deal with the slower-growth environment. We believe heightened uncertainty surrounding the resolution of the European sovereign debt crisis and domestic fiscal policies will continue to create a risk-off environment favoring lower levels of active risk in client portfolios. We remain constructive longer term on investment grade and high yield credit, given the stable credit fundamentals and relatively attractive valuations. Tactically, however, we remain patient for signs of political and macro uncertainties beginning to subside. We also expect the markets to continue pushing the ECB and Euro-area policy makers to coordinate and act decisively to avoid a systemic financial crisis.

We expect overall bond yields to remain relatively low, consistent with steady rates through mid-2013, Operation Twist, sluggish economic growth and relatively contained inflation expectations. We expect the 10-year Treasury to range between 1.50% and 2.50% over the next six to 12 months.

We believe key risks to our economic and market outlook are focused on:

1. The European sovereign debt problem and potential systemic banking and financial crisis
2. The U.S. economy tipping into a double-dip recession due to negative feedback loop risks
3. The U.S. fiscal deficit reduction plan and political debate
4. China's ability to manage a soft landing

Continuation from Core Aggregate Commentary. Please see important information below.

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